

WORLD PRESIDENTS' ORGANIZATION
KELLOGG SCHOOL OF MANAGEMENT

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Economic Outlook

1. Introductory remarks

2. Overview of Economy and Monetary policy
 - a. (Figure) Annual real GDP growth, unemployment and core CPI: 1960-98.
 - b. (Figure) Quarterly real GDP, core CPI and Federal Funds: 1987-98.
 - c. Ratcheting down of inflation relative to 1970s.
 - d. 1990-91 recession was mild and current expansion is long
 - e. Monetary policy implemented by moving Federal funds rate: a simple view of this is a Taylor rule.
 - f. But FOMC looks at much more than just these few data.

3. How does monetary policy really work?
 - a. Discuss structure of Federal Reserve system, FOMC, etc.
 - b. (Handout text) November FOMC minutes and Jordan's dissent.
 - Some context about strong domestic economy and weakening international environment since July 1997 seems necessary
 - This again points to the FOMC's attention to many economic factors, and leads to discussion of spreads.

4. Risk spreads

- a. Russian devaluation in August 1998 and default on debt led to exacerbated international financial situation.
- b. (IMF Figure 1.2) Spread between Emerging Market Bond Index yields and Treasuries.
 - Zero coupon Brady bonds (stripped) v. zero coupon U.S. Treasuries
 - Average spreads are in the 400 to 600 basis point range
 - 1994-95 is Mexican devaluation: political events in first half of 1994 seem evident, loss of dollar reserves in second half, and then the devaluation in December 1994
 - Russian devaluation is evident in August 1998. Monetary policy easing in October.
- c. (IMF Figure 2.4) Spreads for individual sovereign debt indicate fear of contagion
- d. (Evanoff figures) Spreads on Aaa, Baa, and high-yield corporate debt to U.S. Treasuries indicate how this spread to the U.S. economy.
- e. (Evanoff figures) On-the-run and off-the-run Treasury spreads, too.

5. World Economic outlook: Tables from IMF study. Can talk about outlook for 1999.

Two conclusions/implications from this:

- International situation has serious implications for the U.S. economy: this leads to a further discussion of the Asian financial crisis.
- U.S. monetary policy clearly responds to a many different types of data and shocks in order to pursue our mandated goals of sustainable growth and stable prices: It's an interesting question how the European Central Bank will respond differently with the single mandate of price stability.

6. Asian financial crisis

- a. Several countries peg their currency to the dollar: Thailand, Malaysia, Korea, Indonesia, Hong Kong.
- b. Maintaining the fixed exchange rate requires central bank to pursue monetary policies that keep their inflation rates in line with the U.S. policy. This is a discipline on policy: if it is not maintained, there will be a financial crisis.
 - Large sovereign debts which cannot be financed by taxes lead to the speculation that monetary policy will have to monetize the debt. Printing excessive amounts of money leads to inflation and pressure on the currency for devaluation.
 - Large capital inflows, when invested poorly, can create currency crises. If the capital is wasted, then it can't be paid back. When investors sense this, there is a rush to the exits and there is pressure for devaluation.

- Bank bailouts: even if a country has low government debt, their implicit insurance for bailing out inefficient banks can quickly lead to government debt (through the bailout). Pressure to monetize, and currency depreciations.
- c. Thailand devalued in July 1997. What led to this? Not sure: I think they were losing reserves for some reason and they just got to the critical point of not being able to maintain it.
 - d. Korean crisis in October 1997. Inefficient chaebols. Borrowing abroad in dollars. As long as the fixed exchange rate was credible, there's no risk. But when the won was devalued, the dollar denominated debt was more onerous to pay back. Korean reserves had been pledged to forward commitments (unknown to participants), so their reserves levels were too small to withstand pressure.
 - e. How do these crises happen? No explanation seems clear at this point
 - Fundamental shock like an earthquake damaging factories could render bank loans worthless. With no recourse to pay investors, banks could default. Government bail-outs without ability to finance with taxes could lead to the expectation of money creation, inflation and currency devaluations.
 - Animal spirits/Loss of confidence: investors wake up and worry that their (illiquid) loans will not be repaid. If they demand repayment on the illiquid loans (like real estate), then banks could be insolvent and the bailout story continues from there.
 - f. Moral hazard: If bad decisions have no consequences for the investor, then increasingly risky investments may be undertaken. And if investors get behind on their positions, they may “double their bets” in order to make a profit (knowing that their downside is unchanged by this bet while they keep the upside).
 - IMF and banks
 - LTCM and Federal Reserve

Concluding remarks on this topic:

- Need an efficient banking sector. Avoid moral hazard problems. Bailouts are tricky.
- Fixed exchanges rate systems are usually chosen in order to stabilize a previously volatile currency. The cost is that monetary discipline must be maintained. Implicit government guarantees of bailouts may be at odds with the fixed exchange rate guarantee. Design of Central Bank is important: it should be independent, and fiscal policy must finance government activities/guarantees without appealing to inflationary finance methods.

7. Goals of monetary policy and European Central Bank

- a. U.S. policy considers economic activity and inflation. Reputation built during Volcker/Greenspan eras suggests that FOMC will be vigilant against rising inflation, even if inflation were to pop up temporarily.

- b. ECB has no reputation, due to its infancy. The inclusion of countries with a history of financing large fiscal deficits through inflationary finance (Italy, Spain, Portugal), as well as the high unemployment rates in Europe, suggests the possibility of a central bank that will be weak against inflation.
- ECB must prove its resolve against inflation.
 - Less ability to respond to weakening economic activity, relative to the U.S
- c. Many foreign visitors to FRB-Chicago indicate they are interested in “national” policies v. Euro zone policies. How does FOMC consider these issues?
- California during 1990-91 recession and slow recovery: no regional monetary policies. Asymmetric shocks must be accommodated by non-monetary policies or fiscal transfers.
 - Monetary policy is economy-wide policy: San Francisco President votes every 3rd year, but they have 20% of U.S. economy. This is not equitable if Bob Parry’s vote is supposed to be regional: the system is set up to be economy-wide, so there’s no problem.